

Estonian Export Study

Executive Summary

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POLICY LAB



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This study aimed to map the factors supporting and hindering the competitiveness of Estonian exporters and identify any changes in these factors over the past years with the help of Estonian exporters, potential exporters, business support organizations and experts in business and economics. We involved exporters and potential exporters from five major industries where international trade is common and that had export potential and/or had been previously designated as strategic sectors in Estonia's development policies. These included professional, scientific and technical activities; manufacturing; transportation and storage; information and communication; agriculture, forestry and fishing. The study also included companies whose core business is the extraction of peat, but not other companies in the mining and quarrying sector. Financial service providers were only invited to share their ideas in a focus group interview. Tourism and health care services were not included due to the specific nature of these sectors.

The study found that the increase in exports in Estonia slowed down in 2018-2019 reflecting the general slowdown in global trade and economic growth. The COVID-19 crisis led to a sharp decrease in exports of both goods and services in 2020. However, the export of goods managed to demonstrate significant growth already in the last quarter of the year, while exports of services are likely to have decreased somewhat in 2020 compared to the previous year. This is primarily due to a decline in the export of transportation and travel services, two fields that suffered the most from COVID-19 restrictions. Overall, the Estonian economy and exports have adapted quite well to the unusually challenging economic circumstances in recent years, but the effects of the crisis have varied greatly across sectors. The increase in export opportunities in the coming years is also likely to be very uneven in different sectors and target markets.

Two-thirds of the companies surveyed consider the quality of products, efficient organization of work and flexibility of introducing new products to be important competitive advantages for their company. Nevertheless, the labor productivity of Estonia's key exporting industries is still 2-3 times less than that of Finland and Sweden, and manufacturing as the main exporting industry has not really managed to close this gap significantly in the last decade.

In the coming years, companies are planning to develop their existing products as well as to launch new products. The quality of products, introduction of new technologies and smooth organization of work not only within the company, but also in relations with key suppliers and customers, are undoubtedly important contributors to the companies' economic performance.

Digital transformation has been one of the most important sources of economic productivity growth in OECD countries in recent decades. At the same time, only a third of the companies surveyed saw ICT investments as an opportunity to further their competitive advantages. The COVID-19 pandemic led to a surge in e-commerce volumes globally. In Estonia, nearly half of the surveyed companies engaged in e-commerce were slow to react to this change; e-commerce accounted for less than 20% of their revenues in 2020. Aside from the specifics of the products sold, insufficient knowledge and skills, and logistical problems are the biggest obstacles to the development of e-commerce.

An even smaller number of companies pay attention to the objectives and opportunities of the European Union's Green Deal. Only one-fifth of the companies have plans to reduce CO₂ emissions or deploy renewable energy sources in the coming years.

Estonian companies therefore have a lot to do in adopting modern technologies and organizing their daily business even more efficiently, but striving for increasingly efficient organization of work is not a substitute for a functioning business strategy. If the company is in a weak position in the market

(suppliers and customers dictate the terms and conditions of business transactions), then the profit margin remains low even with the most modern technology and organization of work.

Moreover, not all economic activities have the same potential for creating added value. Approximately 60% of Estonia's exports of goods and services come from supplier-dominated industries, which are not knowledge- or technology-intensive. International competition in these industries is focused predominantly on the price of production inputs and efficient organization of work; quality of the products is one of the prerequisites for commercial transactions in these industries, but does not give a significant competitive advantage over competitors offering similar products. Technology-intensive sectors, on the other hand, where the unique quality characteristics of products allow the company to charge customers a high price for their product, account for only 15% of Estonia's exports of goods and services. The peculiarity of Estonia, and indeed the entire Eastern Europe, is that science-based sectors, such as the electronics industry, are dominated by the production units of multinational groups, while the investments in R&D - that are otherwise typical in the field - remain modest.

New export markets which both already exporting companies and potential exporters would like to enter in the future include the Nordic countries and Germany. It is easier for most Estonian companies to expand their market share in a similar business and economic environment, such as their neighboring countries in the Baltic Sea Region, where it is possible to use existing contacts and business networks to break into new markets or market segments. Cooperation with one company belonging to an international group in one Baltic Sea country may lead to cooperation with another company of the same group in another country. The ambition to enter the German market is also understandable, as Germany as Europe's largest economy and exporter can offer companies greater opportunities than the Nordic countries.

24% of the companies surveyed had encountered obstacles hindering their exports, with the number of obstacles varying from country to country. For example, only 6% of companies exporting to the Finnish market experienced obstacles, while this percentage was 20% if the target market was Germany, and 30% if the target market was Russia. The proportion of companies facing obstacles was much higher for the more remote countries: the United States - 39%, Japan - 64%, China - 83%.

Half of those encountering obstacles in their export activities reported regulatory obstacles related to technical requirements. The obstacles related to technical requirements are a particularly acute problem in manufacturing, where two thirds of the companies surveyed have experienced them. And it is not only the requirements in third countries that are a problem. There are standards and regulations, which could potentially apply across the entire European Union, but which only a few member states implement. In addition, there are member states who require companies to meet certain technical requirements that are not imposed in other countries. This makes it difficult for the companies to operate even in the internal market of the European Union, as they are not familiar with the legislation of different member states.

When planning future export support measures, it should certainly be taken into account that Estonian exports are highly concentrated with a small number of companies doing most of the export. Companies with 50+ employees, i.e., around 5% of all exporting companies, account for approximately two-thirds of Estonia's export of goods. The product portfolios and number of target markets of medium-sized and bigger companies are typically significantly larger than those of small companies. Finding the resources for export marketing or covering other minor costs is usually not a problem for these companies. Removing some of the obstacles hindering the development of these larger companies can, however, significantly increase Estonia's export income.

The shortage of qualified workforce, for example, continues to be a major problem for companies. Difficulties in finding qualified workforce prevent companies from moving to new, more complex product groups and hinder their ability to invest in new technologies and automate their activities.

Difficulties in finding highly qualified managers and specialists are preventing companies from increasing their export volumes, entering new markets and investing more in product development.

The companies' awareness of available state support measures and activities is the strongest in the case of support measures provided by Enterprise Estonia. Awareness of Brand Estonia toolbox and export-oriented activities of the Ministry of Foreign Affairs, including the support offered by embassies, honorary consuls and in the field of business diplomacy, is somewhat lower. Previous studies into the impact of business support measures have found the existing export support measures to be appropriate, efficient and effective. However, there is always room for improvement when it comes to developing and increasing the impact of business support measures. For example, one of the key questions is how to ensure an individual approach to larger exporting companies, including potential new foreign investments, each of which brings considerable export income to Estonia, while also providing appropriate support for the many micro and small companies with highly diverse needs.

The policy recommendations aimed at increasing export income take into account that the world's recovery from the health and economic crisis and the expected future economic growth is likely to be very uneven in different sectors and target markets. In addition, Europe is moving towards implementing a digital and green economic model by 2050, which is also going to have a direct impact on all Estonian companies.

Recommendations aimed at further developing the competitive advantages of Estonian companies fall into two broad categories.

- (1) **Moving to new, more complex product groups.** Increasing the labor productivity of exporting companies is the most critical issue that needs to be addressed for increasing Estonia's export income. It is also important to help Estonian companies focus on increasing the market share of their exports, especially in moving to product groups and target markets with rapidly growing demand, where both added value and export volumes can be increased. Preference should be given to those product groups which are (a) closer to today's capabilities and (b) create more opportunities for moving to other more complex product groups. We recommend selecting 5-7 export areas with a breakthrough potential and creating at least 10-year road maps for developing their export capabilities, describing Estonia's opportunities for moving to more complex product groups and the dynamics of demand in relevant export markets, availability of suitable workforce, applicable technologies, the need to attract domestic capital and foreign investment, etc. For those sectors and product groups that are found to be promising in the process of roadmapping, but are for some reason not viable for local companies and investors, we recommend that the government consider using a proactive foreign investment strategy.
- (2) **Increasing productivity in today's key exporting industries.** The availability of qualified workforce, industrial research carried out by companies, continuous development of products, work processes and business models all play a vital role in increasing productivity. Companies see the lack of qualified workforce as their biggest challenge. Estonia's current support measures are generally appropriate for supporting companies with different levels of risk and technology intensity. We recommend increasing the support aimed at enabling the cooperation of exporting companies with specialized suppliers, especially those providing information and communication systems, automation solutions, specialized production equipment, environmental and energy technologies, as well as designers and architects who have the potential to make an important contribution to developing new products with better quality characteristics and updating the business models of exporting companies.

Recommendations aimed at expansion of exports in target markets also fall into two categories.

- (3) **Entering new target markets.** Key recommended new target markets include China and other Asian countries, including Indonesia, Bangladesh, Pakistan, Vietnam and Malaysia, which are expected to continue rapid economic development with the help of both population growth and increasing economic complexity. Plans for entering new target markets should also include Africa, which has a rapidly growing population. For the small number of larger companies, who account for the majority of Estonian exports, a more personal and flexible approach could be justified targeted specifically at overcoming the main obstacles to their development. Medium-sized and larger companies have sufficient resources to visit trade fairs and find contacts in the new target markets. Supporting their export activities often means addressing regulatory or organizational issues instead, for example by mediating high-level contacts in new target markets or other such activities, which do not necessarily require a financial contribution from the state. In terms of smaller companies, fast-growing start-ups whose product's market demand is quite uniform globally are of particular interest when it comes to entering more distant markets. In order to support the emergence and rapid growth of such companies, the seed and venture capital market should be developed even further with an even greater focus on attracting international seed and venture capital, which would support the development of business models, the rapid growth of companies and their expansion in foreign markets. In certain sectors, e.g., software services, it makes more sense to open foreign branches or subsidiaries due to the specifics of market demand or attracting capital in these fields. We therefore recommend that direct investments from Estonia and the repatriation of related profits be considered as part of the export strategy.
- (4) **Increasing market share in key target markets.** One of the easier ways for small and medium-sized companies to expand their export market and increase export income is to enter the supply chain of larger exporting companies or multinational groups and specialize on increasingly more complex products within this supply chain. In terms of the foreign investment strategy, this links investments made in Estonia and the Baltic Sea Region more firmly to the region as a whole and keeps such companies from relocating when economic circumstances should happen to change. In terms of generating export income, building a network of smaller suppliers around larger companies with wider export geographies would significantly increase both the volume of (indirect) exports and the added value created in the country. Both SMEs and larger companies would like to see a more comprehensive B2B network, either based on a particular export destination or aimed at a wider geographical or economic region, which would enable communication with parties in different supply chains. Such a network would also provide an opportunity to raise funds, bring together parties with the common problems and solutions in different countries, and allow companies that are bigger and higher up in the production chain to find potential suppliers. This B2B network would also make it possible to analyze market demand in different product groups and allow companies to cooperate in entering or expanding in certain markets. We recommend making the most of the opportunities offered by various business support organizations (including professional associations) and international business networks to support exports to nearby markets. Business support organizations can help companies enter new markets by promoting the sector at trade fairs and other similar events, organizing product development and export focused networking events, facilitating the exchange of experiences to overcome target market-specific regulatory obstacles (e.g., certification requirements), providing industry-specific market reviews, etc. In order to increase market share in certain sectors, such as the food industry or manufacturing, it is important to establish direct contacts in some countries (e.g., Germany). The measures currently offered by the state for visiting various trade fairs and awarding grants to companies who have to visit trade fairs will serve this purpose well.

The study built on an analysis of the companies' economic indicators, an on-line survey and focus group interviews.

The study relied as much as possible on public data from the Estonian public sector (including data from the Estonian Tax and Customs Board, the commercial register, the register of state aid and de minimis aid) in an effort to reduce the additional administrative burden on companies the study would have otherwise created. The open data of the Tax and Customs Board was also used for identifying economically active companies to participate in the on-line survey.

A questionnaire was designed for the on-line survey of companies that focused on mapping the business models of companies and their development, as well as the companies' export experience and obstacles encountered in their export activities. A total of 21,042 companies were invited to participate in the on-line survey. Representatives of 1,021 companies responded to the survey, and the answers can be considered representative in terms of both the sectors and the number of employees.

Qualitative information gathered through focus groups with entrepreneurs helped to interpret, complement and clarify the quantitative data and explore the companies' problems, bottlenecks and needs in more detail. A total of 4 focus groups were conducted with the representatives of 26 different companies. One of the focus groups was designed to include only representatives of companies operating in the FinTech sector.

The findings of the study as well as the initial policy recommendations were discussed with experts. This workshop was attended by 28 representatives from the public sector, business representative organizations, professional associations and business support organizations.